that lack television reception.[2] The Commission has taken the position that providing a priority for translators, would, among other things, greatly diminish origination flexibility for translators.[3] Such a position reflects a lack of sensitivity to the fact that to the rural citizen with no television service, any service now is much more useful than service later that might be superior because of origination capacity.

In any event, the Commission has now procrastinated to such an extent that anything we could do now will not make up for the years of service to rural areas that was lost. To the contrary, the *Report and Order* states that attempting now to give translators priority will only exacerbate the delay.[4] Given that statement, the commitment I have received from the Mass Media Bureau that it will process single applications which come from rural areas first and the Bureau's assurances that rural translator applicants will be less likely to be subject to mutually exclusive applications under the new processing system, I feel the best course is to concur. If I were writing on a clean slate, I certainly would have done things differently.

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BILLING CODE 6712-01-M

[2] For example, tiered processing could have included evaluation of Tier I (rural) applications without regard to Tier II and Tier III (urban) applications; additionally, at several points, various commenters pled with the Commission to maintain a processing distinction between translator and LPTV applicants.

[3] *See e.g., Report and Order*, paras. 5, 14 and 17–26.

[4] *Report and Order*, para. 23.

INTERSTATE COMMERCE COMMISSION

49 CFR Part 1057

[Ex Parte No. MC-43 (Sub-15)]

Elimination of Thirty Day Leasing Requirement

AGENCY: Interstate Commerce Commission.

ACTION: Final rule.

SUMMARY: The Commission adopts final rule modifying Part 1057 of the Commission's vehicle leasing regulations by eliminating the requirement that equipment be leased for a minimum duration of 30 days when operated by its owner. The Motor Carrier Act of 1980 promotes increased competition to meet a number of important goals, among them fair wages and working conditions, productive use of equipment, and meeting the needs of shippers, receivers, and consumers. Permitting lessors to lease equipment for less than 30 days will offer the potential for increased earnings by lessors who now find themselves party to a 30-day lease with no freight to haul. Such lessors could trip-lease to other carriers.

EFFECTIVE DATE: This decision is effective on January 7, 1985.

FOR FURTHER INFORMATION CONTACT: Robert G. Rothstein, (202) 275-7912 or Mary Kelly, (202) 275-7292.

SUPPLEMENTARY INFORMATION: Proposed rules were published at 48 FR 39251, August 30, 1983; comment period extended for 30 days at 48 FR 44590, September 29, 1983.

Additional information is contained in the full Commission decision which is available for public inspection and copying at the Office of the Secretary, Interstate Commerce Commission, or may be purchased from TS Infosystems, Inc., Room 2227, Interstate Commerce Commission Building, 12th St. and Constitution Ave., NW., Washington, DC 20423; or call toll free (800) 424-5403, or (202) 289-4357 in the Washington, DC, metropolitan area.

Environmental and Energy Considerations

We adopt the preliminary finding in the notice that this action will have no significant impact on the quality of the human environment or conservation of energy resources. No specific comments were submitted on any matter indicating that a contrary position is warranted. We reaffirm our earlier position that this rule modification will improve operating efficiency.

Regulatory Flexibility Analysis

The rules modifications adopted here will confer a significant, beneficial economic impact upon lessors of equipment by allowing more efficient equipment utilization during periods when their equipment might not otherwise be used. Authorized carrier lessees will realize a benefit in that they can augment their equipment with that leased for less than 30 days, thus offering improved service to the public. At the same time, they will be responsible for controlling equipment only for the precise time needed. These advantages to the lessee should benefit the public in the form of improved service and lower rates. The rules modification address the congressionally-mandated goal of efficient and productive utilization of equipment and energy resources, and reaffirm the agency's responsibility to encourage safe, adequate, and efficient transportation.

List of Subjects in 49 CFR Part 1057

Motor carriers.

Adoption of Rules

Accordingly, we adopt the revisions to Title 49, Part 1057, of the Code of Federal Regulations as described in Appendix B to this decision.

This action is taken under the authority of 49 U.S.C. 10321 and 11107 and 5 U.S.C. 553.

Decided: November 27, 1984.

By the Commission, Chairman Taylor, Vice Chairman Andre, Commissioners Sterrett, Gradison, Simmons, Lamboley, and Strenio.

James H. Bayne,
Secretary.

Appendix

PART 1057—[AMENDED]

Part 1057 of the Code of Federal Regulations, Title 49, is amended as follows:

1. Section 1057.2 is amended as follows:

a. Paragraph (d) is revised to read as follows:

§ 1057.2 Definitions.

* * * * *

(d) *Owner*—A person (1) to whom title to equipment has been issued, or (2) who, without title, has the right to exclusive use of equipment, or (3) who has lawful possession of equipment registered and licensed in any State in the name of that person.

* * * * *

b. Paragraphs (f) and (g) are removed.

c. Paragraphs (h), (i), (j), (k), (l), (m), (n), and (o) are redesignated as paragraphs (f), (g), (h), (i), (j), (k), (l), and (m), respectively.

2. Section 1057.11 is amended as follows:

a. Paragraph (d)(1) is revised to read as follows:

§ 1057.11 General leasing requirements.

* * * * *

(d) * * *

(1) The authorized carrier shall prepare and keep documents covering each trip for which the equipment is used in its service. These documents shall contain the name and address of the owner of the equipment, the point of origin, the time and date of departure, and the point of final destination. Also, the authorized carrier shall carry papers with the leased equipment during its operation containing this information and identifying the lading and clearly

indicating that the transportation is under its responsibility. These papers shall be preserved by the authorized carrier as part of its transportation records. Leases which contain the information required by the provisions in this paragraph may be used and retained instead of such documents or papers.

* * * * *

b. Paragraph (d)(2) is removed and reserved for future use.

3. Section 1057.12 is amended as follows:

a. Paragraph (c) is removed.

b. Paragraph (g) is revised to read as follows:

§ 1057.12 Written lease agreements.

* * * * *

(g) *Payment period*—The lease shall specify that payment to the lessor shall be made within 15 days after submission of the necessary delivery documents and other paperwork concerning a trip in the service of the authorized carrier. The paperwork required before the lessor can receive payment is limited to log books required by the Department of Transportation and those documents necessary for the authorized carrier to secure payment from the shipper. The authorized carrier may require the submission of additional documents by the lessor but not as a prerequisite to payment. Payment to the lessor shall not be made contingent upon submission of a bill of lading to which no exceptions have been taken. The authorized carrier shall not set time limits for the submission by the lessor of required delivery documents and other paperwork.

* * * * *

c. Paragraphs (d), (e), (f), (g), (h), (i), (j), (k), (l), (m), and (n) are redesignated as paragraphs (c), (d), (e), (f), (g), (h), (i), (j), (k), (l), and (m), respectively.

d. The reference to "paragraph (d)(1)" in the newly redesignated paragraph (c)(3) is revised to read "paragraph (c)(1)".

e. The reference to "paragraphs (e)–(l)" in the newly redesignated paragraph (m) is revised to read "paragraphs (d)–(k)".

4. Section 1057.22 is amended as follows:

a. The heading and paragraph (6) are revised to read as follows:

§ 1057.22 Exemption for private carrier leasing and leasing between authorized carriers.

* * * * *

(b) The lessor must own the equipment or hold it under a lease.

* * * * *

§ 1057.23 [Removed]

5. Section 1057.23 is removed.

§ 1057.24 [Removed]

6. Section 1057.24 is removed.

§ 1057.25 [Removed]

7. Section 1057.25 is removed.

[FR Doc. 84-31996 Filed 12-6-84; 8:45 am]

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Proposed Rules

Federal Register
Vol. 49, No. 237
Friday, December 7, 1984

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

FEDERAL HOME LOAN BANK BOARD

12 CFR Parts 561, 563, 570, 571, and 584

[No. 84-681]

Net-Worth Requirements of Insured Institutions

Dated: November 30, 1984.

AGENCY: Federal Home Loan Bank Board.

ACTION: Proposed rule.

SUMMARY: The Federal Home Loan Bank Board ("Board"), as the operating head of the Federal Savings and Loan Insurance Corporation ("FSLIC" or "Corporation"), is proposing to amend its regulations pertaining to the minimum net-worth requirements applicable to all institutions the accounts of which are insured by the FSLIC ("insured institutions"). The proposed rule would result in the elimination, through a straight-line amortization over five years, of the authority to (1) calculate the net worth on a five-year-average basis (except for institutions having $100,000,000 or less in assets and that increase their liabilities at a rate not exceeding 15 percent) and (2) phase in the requirement over a twenty-year period. The determination of the net-worth requirement would be changed from an annual basis calculated at the beginning of the year to a quarterly basis calculated at the end of each calendar quarter. Institutions would be required to have the minimum necessary amount at the end of the quarter rather than at the end of the year. The proposal would also impose a net-worth requirement equal to a percentage of any quarterly increase in liabilities, with the percentage varying with the amount of growth: three percent of any liability growth would be required if an insured institution grew at an annual rate of fifteen percent or less, measured from the corresponding calendar quarter of the preceding year; four percent would be required on quarterly growth if the growth was at an annual rate between fifteen percent and twenty-five percent; and five percent would be required on quarterly growth if the growth was at an annual rate in excess of twenty-five percent. The proposal would permit an institution to reduce the amount of its net-worth requirement to reflect a quarterly decrease in liabilities. Minimum net worth would continue to include two percent of recourse liabilities plus twenty percent of scheduled items. An additional amount equal to ten percent of certain direct investments would also be included in minimum net worth under the proposal. The Board is also proposing to eliminate the requirement to calculate "statutory reserves" as a percentage of insured deposits. Instead, compliance with the net-worth requirement would be considered sufficient. The Board is also proposing to require institutions with assets in excess of $100,000,000 to obtain prior approval before increasing liabilities in any quarter at an annual rate in excess of twenty-five percent. This proposal is in furtherance of the rulemaking pertaining to the Board's net-worth requirements initiated by the proposal issued by the Board on February 15, 1984, Resolution No. 84-81 (49 FR 6501, February 22, 1984) and as such, supersedes that proposal.

The Board is proposing to impose a marginal net-worth requirement on the quarterly growth in liabilities because the Board believes that the ability to leverage new liabilities beyond 33 to 1 is excessive. The Board is also concerned that the excessive growth of thrift institutions' liabilities, unsupported by additional net worth, increases the risk to the FSLIC. The proposed regulation would not necessarily require associations to generate new net worth to support net additions to liabilities. To the extent that institutions have net worth above current regulatory minimums, they can use this net worth to support additions to liabilities. The Board believes that a principal problem faced by the thrift industry is the rapid growth of thrift institutions which do not have adequate levels of capital to support that growth. This problem is seriously exacerbated by current regulations which permit thrifts to use a five-year averaging formula in calculating their minimum net-worth requirements, as well as a twenty-year phase-in of required net worth for new institutions. Further, the Board is concerned that the current lag between the date of calculation and the date upon which the requirement is to be met hampers the Board's supervisory abilities. If the proposed amendments are adopted substantially as proposed, they would become effective for any calendar quarter beginning January 1, 1985, and thereafter calculated and required to be met at the end of such quarter.

DATE: Comments must be received by December 31, 1984.

ADDRESS: Director, Information Services Section, Office of the Secretariat, Federal Home Loan Bank Board, 1700 G Street, NW., Washington, D.C. 20552. Public comments received on this proposal and materials referred to in the preamble of this document will be publicly available at this address.

FOR FURTHER INFORMATION CONTACT: Robert S. Monheit, Attorney, Office of General Counsel, (202) 377-6448; Edward Taubert, Deputy Associate Director, Policy Development, Office of Examinations and Supervision, (202) 377-6484; or Robert J. Pomeranz, Policy Analyst, Office of Policy and Economic Research, (202) 377-6209, Federal Home Loan Bank Board, at the above address.

SUPPLEMENTARY INFORMATION: The Garn-St Germain Depository Institutions Act of 1982 ("DIA"), Pub. L. 97-320, amended section 403(b) of the National Housing Act ("NHA"), 12 U.S.C. 1726(b), by deleting the language that limited the FSLIC's regulatory authority concerning adequate reserves to requiring reserves in an amount no greater than 6 percent nor less than 3 percent of all insured accounts within a reasonable time, not exceeding twenty years. The DIA requires all insured institutions to "provide adequate reserves in a form satisfactory to the Corporation, to be established in accordance with regulations made by the Corporation", 12 U.S.C. 1726(b). Thus, the DIA eliminated (1) the reference to insured accounts as the basis of the calculation, (2) the percentage range that previously limited the Board's discretion to set reserve requirements, and (3) the direction to phase in the requirement over not more than twenty years, and it granted the FSLIC explicit broad authority over reserve requirements for all insured institutions.

Current regulations. Section 563.13 of the insurance Regulations (12 CFR 563.13 (1984)) sets forth a "statutory reserve" requirement and a "minimum net worth" requirement which the Board has used, in part, to gauge capital adequacy. The minimum net-worth requirement differs from the statutory-reserve requirement in that net worth is calculated as a percentage of total liabilities rather than as a percentage of insured accounts, and the calculation of minimum net worth includes two percent of recourse liabilities and twenty percent of scheduled items. Both the minimum net-worth requirement and the statutory-reserve requirement permit institutions to calculate liabilities and deposits, respectively, by averaging the past fiscal year with the preceding four fiscal years (a procedure known as "five-year averaging"). Also, institutions that have not reached their twentieth anniversary of insurance are permitted to phase in the net-worth and statutory-reserve requirements by multiplying three percent of liabilities and deposits, respectively, by a fraction the numerator of which is the number of consecutive years of insurance and the denominator of which is twenty (a process known as the "twenty-year phase-in").

In the rulemaking proceeding concerning reserve requirements and other policies pertaining to insurance of accounts of de novo institutions (proposed: Board Res. No. 83-608, 48 FR 51,270 (Nov. 10, 1983); final: Board Res. No. 83-653, 48 FR 54,320 (Dec. 2, 1983)), the Board found sufficient cause to require de novo institutions to have statutory reserves and net worth equal to at least seven percent of insured deposits and liabilities, respectively, for the first full fiscal year, with the requirement gradually decreasing to three percent of deposits and liabilities, respectively. The Board noted in the preambles of both the proposed and final rules that it would continue to review the statutory-reserve and net-worth requirements and other areas of concern relating to existing institutions.

February proposal. On February 15, 1984, the Board proposed a revision of the statutory-reserve and net-worth requirements of insured institutions other the *de novo* institutions (Board Res. No. 84-81, 49 FR 6,501 (February 22, 1984), hereafter referred to as the "February proposal"). The Board expressed concern that the recent rapid growth of many insured institutions had markedly reduced the capital coverage in an industry that has experienced chronic capital deficiencies. Further, the Board noted that recent changes in federal and many state laws had significantly widened the investment powers of federal and state-chartered institutions, permitting investment in areas in which insured institutions have little experience. The Board concluded that the ability of insured institutions to increase significantly their liability base without adequate capital, combined with the increased risks as a result of the DIA and changes to a number of state laws, had materially increased the risk exposure of the FSLIC. Therefore, the Board proposed a number of revisions to strengthen the capital adequacy of thrift institutions insured by the FSLIC.

Specifically, the February proposal incorporated three major changes to address there concerns. First, a requirement was proposed to maintain net worth at three percent on any increase in liabilities incurred after December 31, 1983. This action would limit leveraging of new liabilities to 33 to 1. All institutions (other then *de novo* institutions) would multiply increases in liabilities between December 31, 1983, and the date of calculation by three percent. *De novo* institutions that had not reached the three-percent requirement would continue to calculate minimum net worth as required under the existing rule, which does not permit five-year averaging. Institutions experiencing no growth in liabilities would not be adversely affected by the proposal. Institutions experiencing a decrease in liabilities after December 31, 1983, would be treated as if they had experienced no growth.

Second, the February proposal would gradually eliminate five-year averaging and the twenty-year phase-in. Five-year averaging would be eliminated by gradually reducing the number of fiscal years which could be averaged. For example, assuming that an institution chose to use this technique, it would average, in the first fiscal year following September 30, 1984, the liabilities in fiscal years 1983, 1982, 1981, 1980, and 1979. In the next fiscal year, the institution would average fiscal years 1983 through 1980. In the third year, it would average fiscal years 1983 through 1981. Finally, in the fourth year, the institution would average fiscal years 1983 and 1982. Thereafter, averaging would not be permitted. The twenty-year phase-in would be gradually eliminated by permitting gualified institutions to apply this procedure only to pre-December 31, 1983, levels of liabilities. Any increase in liabilities after that date would be multiplied by three percent. An institution having received approval for insurance of accounts prior to November 3, 1983, however, would continue to multiply three percent of pre-December 31, 1983, liabilities by a fraction the numerator of which is the number of consecutive years of insurance and the denominator of which is twenty, unitl the institution reaches the twentieth anniversary of insurance of accounts. Once all institutions insured prior to November 3, 1983 reach the twentieth anniversary of insurance of accounts, the phase-in would be entirely eliminated.

Third, the Board proposed to eliminate the "statutory reserve" test of 12 CFR 563.13(a) The DIA amendment indicates that Congress no longer intends to restrict the Board to imposing a capital adequacy standard based upon insured deposits. The Board believes that the minimum net-worth standard is a more reliable guage of capital adequacy because it is calculated upon total liabilities, not merely insured deposits. This amendment would also alleviate the burden of calculating two measures of capital adequacy that are largely duplicative. Therefore, the Board proposed to make compliance with the minimum net-worth requirement sufficient for compliance with the reserve requirement of 403(b) NHA. State requirements tied to the reserve requirement of 403(b) would be met by compliance with the proposed net-worth requirement.

Comments on Net-Worth Proposal

The Board received 199 public comments in response to its proposal. The majority (143) of the comments were submitted by thrift institutions. Of the remaining comments, seventeen comments were received from trade associations, one each from a state regulator, a member of Congress, a law firm, and a federal financial regulatory agency, two letters were received from other entities, including financial groups, and 33 letters were received from interested individuals. Most (184) of the commenters opposed the Board's proposed rule. However, 158 commenters did express the view that the net worth of insured institutions should be increased, but indicated reservations regarding the timing or approach of the proposal and suggested alternatives. The Board has carefully reviewed these comments on the net-worth proposal, which are discussed more fully below.

Discussion of Issues Raised by Commenters. Many commenters indicated that the net-worth proposal would effectively eliminate a substantial amount of the "excess" net worth of the thrift industry, and adversely affect a substantial number of thrifts. While the

Board is cognizant of these concerns, it has become obvious that the relative laxity of the present net-worth requirements actually encourages tremendous growth supported by inadequate levels of reserves or capital. Several years ago, the Board lowered the regulatory net-worth requirements to encourage and support the restructuring of asset/liability portfolios of thrifts in order to reduce the sensitivity of the industry to interest-rate fluctuations. That approach was appropriate when interest-rate risk was the predominant concern of the industry. However, the recent deregulation of both assets and liabilities of thrift institutions has removed the traditional limitations on risk-taking and has made adjustable-rate mortgages widespread. In this new environment, it has become increasingly obvious that credit risk is at least as serious a concern to the industry as interest-rate risk. Accordingly, insured institutions and the FSLIC must take steps to obtain and retain sufficient capital to offset this exposure.

Growth, Profitability, and Viability. Several commenters argued that the changes in the proposed regulation would limit the growth and profits of a majority of institutions, since all new growth would have to be earned, and most institutions would not be able to generate a sufficient spread to cover the increased net-worth requirement. Additionally, a few commenters believed that thrifts would lose their customer base if they had to stop growing. While the Board is sensitive to these concerns, it is persuaded that an increase in the capital base, in fact, supports well-planned growth and prosperity of the industry, and that institutions weakened by growth without an adequate reserve cushion present inordinate risks. Numerous economic and financial studies indicate that capital serves five functions for financial institutions: (1) Absorbs losses so that an institution can continue to operate in times of financial difficulty; (2) supports growth, (3) serves as a barrier to imprudent investment decisions, (4) acts as a source of additional protection to depositors during less favorable economic periods, and (5) enhances public confidence. Further, capital serves as additional protection to the FSLIC by offsetting losses which would otherwise have to be borne by the FSLIC. Thus, the establishment and maintenance of an adequate net-worth base for the thrift industry promotes long-term profitability and prudent growth. Only with a sufficient capital base can the thrift industry continue to manage effectively its asset/liability mismatches and simultaneously improve its position in the financial arena.

Several commenters expressed concern that the proposal would present an insurmountable obstacle to growth in a rising interest-rate scenario because an institution with net worth at or below the current regulatory level would be required not only to earn the requisite three percent on "new liabilities" but also to offset any "drag" that the rise in rates would impose upon pre-existing liabilities. The Board believes that inadequacy of the present capital requirements mandates the prudent and gradual increase of regulatory net-worth requirements to mitigate the additional credit risk caused by the exercise of expanding investment authority and any increased interest risk if inflation increases. Moreover, the "marginal net worth" approach is sensitive to the difference between the increased sophistication in the management of interest-rate spread (which should be part of every plan for acquisition of new assets and liabilities being placed on a thrift's books) and the management decisions made prior to deregulation. In sum, the Board recognizes the inflexibility in part of the existing thrift portfolio, but believes that an increase in the net-worth base of the industry is necessary to provide additional protection to the FSLIC insurance fund, to serve as a cushion against losses incurred by institutions, and to maintain public confidence. Taken in conjunction with the Board's recent actions directed at improved asset/liability management, the industry as a whole should be in a better position to exist in a volatile interest-rate environment.

Restructuring Effects. Many commenters, primarily thrift institutions, supported a delay in implementation to accommodate the restructuring taking place in the industry. Proponents of delayed implementation stressed that by limiting growth, the proposal would hinder restructuring which is essential to mitigate thrift maturity mismatch problems. A number of comments emphasized that more time was necessary to utilize the new asset flexibility provided by deregulation, ultimately enabling insured institutions to meet increased net-worth requirements at a later date. Still others suggested that recent regulatory actions, such as the new requirements for *de novo* institutions, may negate the need for the proposed regulation. Finally, commenters indicated that the proposed regulation would shift the emphasis from restructuring to maintaining current earnings to meet net-worth requirements and would require extensive amendment of business plans. In this regard, commenters contended that the proposal would result in increased service fees and an undue emphasis is on maximizing returns on investments in order to generate the net return on assets to meet the proposed net-worth requirements, thereby increasing the level of risk to the institution and ultimately the FSLIC.

While the Board recognizes that institutions in existence prior to 1980 need some growth in order to restructure their interest-rate gap and to build a new asset base, the proposed regulation will allow prudent growth. It is well documented that not all institutions are using growth to restructure in a prudent, safe and sound manner. In fact, some institutions are growing so rapidly that the management of such institutions is unable to make prudent investment decisions or to implement proper underwriting techniques in order to ensure the acquisition of sound assets. An institution that cannot support its growth with an accompanying increase to net worth is not really curing its asset-structure problems, but merely deferring them by front-loading the income associated with growth, to the longterm detriment of the institution. The Board's review indicates that the new asset base of thrift institutions, attained through rapid growth over the past few years, has not necessarily deceased the risk to the insurance fund but, in fact, has often increased that risk.

Moreover, the Board believes that the proposed tightening of net-worth requirements and the linkage of an acceptable level of net worth to growth would not inhibit or delay institutions from using prudent growth to restructure their asset portfolio. The Board's research (described in detail below) indicates that substantial restructuring (from fixed-rate mortgages to adjustable-rate mortgages) can be accomplished within the next five years utilizing a growth rate of 15 percent.

Accordingly, while the Board supports the restructuring efforts of the industry as a whole and recognizes that interest-rate gap management is an effective tool to protect insured institutions and ultimately the FSLIC from interest-rate spread risks, it has preliminarily concluded that such restructuring without adequate capital does not adequately protect the FSLIC from increasing credit risk as a consequence of thrifts operating in a deregulated environment. The restructuring efforts of many rapidly growing institutions have resulted in investments of a highly speculative nature, greatly increasing the credit risk to the FSLIC. The Board believes that increasing the capital requirement for thrift institutions would provide the FSLIC with necessary additional protection in a deregulated environment. Furthermore, matching the expansion of an institution's asset and liability portfolio, regardless of size, with a marginal contribution to net worth establishes a realistic equity stake by the owners in the institution, and therefore serves as an important form of market discipline.

Effect on Housing Role. Other concerns raised by the comments focused on the likelihood that thrifts would be forced to focus on non-housing-related investments such as real estate, commercial and consumer lending to support the requirement that all growth must be matched by higher capital levels. As discussed more fully below, this contention ignores the fact that (1) the regulation would allow prudent growth, and nondirect investments (e.g., ARMs) can fund growth without undue risk, (2) a significant majority of thrift institutions possess substantial "excess" net worth which can offset increases in liabilities, (3) additional net worth can be obtained through access to the capital markets, and (4) an institution which cannot support its growth with prudent reserves should not grow. The Board believes that a profitable, well-managed, appropriately diversified and sufficiently capitalized thrift institution is better able to provide a substantial and stable source of home financing to the public than an institution that does not have sufficient capital to cushion potential losses.

Disparate Effect on Mutual and Stock Institutions. Some commenters suggested that the proposal would have a particularly significant effect on mutual institutions, presumably because of a lack of access to the capital markets, and thus would encourage more stock conversions. The Board, however, is not persuaded by that argument. First, earning can support prudent growth. Second, for institutions that require substantial capital infusions to support their growth, conversions are appropriate. While the Board continues to take steps to facilitate the mutual-to-stock conversion process, it also realizes that mutual institutions are a significant element of the thrift industry and comprise approximately 65 percent of all insured institutions. Third, mutuals can use the capital markets through the issuance of subordinated debentures and mutual capital certificates. Moreover, while stock institutions have raised substantial amounts of capital during the last few years, the Board's supervisory experience indicates that many stock institutions have employed that capital to grow to or past the levels which can be adequately supported by their net worth. Board studies demonstrate that stock institutions with a net worth greater than three percent grew more than 60 percent between June, 1983, and June, 1984, as compared to a growth rate of approximately 11 percent for mutuals during the same period. Stock institutions with net worth of less than three percent grew approximately 50 percent between June, 1983, and June, 1984, while mutual institutions with similar net-worth levels grew approximately 16 percent. Another study shows that approximately the same percentage of mutual and stock institutions have relatively equivalent levels of net worth up to five percent of liabilities. Accordingly, the Board has concluded that the proposal is not particularly inimicable to the interests of mutual institutions.

Other commenters expressed concern about the effect of higher net-worth requirements on the raising of capital by stock institutions in the public market since the proposal limits a thrift's leveraging possibilities. The leveraging factor was labeled "the most attractive feature of stock thrift institutions to investors." In response, the Board believes that this approach toward investment in thrift institutions leads to the use of institutions to fund speculative and risky ventures in which the FSLIC, rather than individuals contributing risk-capital, is intended to absorb the losses. This is supported by studies which have indicated that capital in financial institutions should serve as a barrier to imprudent investment decisions. Thus, to the extent that the proposal would discourage those investors seeking only highly leveraged investment opportunities, the Board believes that the proposal is appropriate. Adequately capitalized, well-managed thrift institutions should be considered an attractive and sound investment in the public market.

Industry Consolidation. Several commenters expressed the view that more mergers between thrifts with net-worth problems and institutions with excess net worth would occur as the result of the proposal. Although the Board does not anticipate a greater number of voluntary or supervisory mergers as a result of the promulgation of a higher net-worth requirement, it welcomes the submission of any empirical data by commenters on the revised proposal addressing this contention. One commenter requested that the Board provide some type of forbearance for a limited period of time for the resulting institution in a merger involving purchase accounting, since the net worth of the acquired institution disappears. The Board has addressed this point in its revised proposal, which is discussed below.

Competitive Concerns. Other commenters opined that the proposal would interfere with the ability of thrift institutions to compete with commercial banks and other financial institutions. The Board believes that this comment ignores several obvious factors and is, therefore, without merit. At present, commercial banks are subject to a much more stringent capital requirement, so that those institutions have far more limited leveraging possibilities than insured institutions. In fact, the federal bank regulatory agencies have proposed regulations or guidelines which would increase those levels (see later discussion). Further, commercial banks are required to utilize generally accepted accounting principles, rather than the more permissive regulatory accounting principles that insured institutions may use. Finally, it should be noted that the thrift industry aggregate growth rate from June, 1983 to June, 1984 was 19 percent, whereas domestic-chartered commercial banks during this period had an annual growth of approximately 11.3 percent. Given these considerations, the Board does not believe that the relatively modest tightening that would be imposed by either the initial proposal or the reproposal (see later discussion) would adversely affect the ability of thrifts to compete with commercial banks.

With respect to other financial institutions that are not federally insured, thrifts do have some competitive advantages. Thrift institutions are partially insulated from free-market discipline with respect to obtaining funds for investments. For instance, a thrift institution, unlike non-federally-insured institutions, may borrow on a long-term basis for up to 20 years from its Federal Home Loan Bank at market rates and can attract insured deposits at or below market rates, regardless of its financial condition or net-worth level.

The Board agrees with the other federal regulators of financial institutions that the capital base of federally insured financial institutions must be increased in order to maintain public confidence during times of intense competition for financial services, to offset risks resulting from deregulation and to counter the FSLIC's losses from defaulting financial instituions.

Factual Basis. Several commenters suggested that the proposal inappropriately penalized all thrifts, especially those with a conservative asset/liability management strategy, because of a relatively small number of problem institutions whose troubles resulted from the imprudent investment of brokered funds. The Board, however, disagrees with that contention. For example, the FSLIC reserves-to-deposit ratio, which peaked at 2.12% in 1970, has declined to 0.92 percent by September, 1984. When the shrinking reserves-to-deposit ratio is coupled with the heightened risks to the industry emanating from increased participation, for example, in acquisition, development and construction lending, as well as other high-yield/high-risk ventures, a gradual program to upgrade required levels of net worth is entirely appropriate for all insured institutions.

Some commenters contended that thrift institution failures are the result of maturity mismatches of assets and liabilities and not from asset problems. However, data developed by the Board's staff indicate that there is a disturbing increase in number and correlation of failures due to imprudent credit risks fueled by excessive growth. For example, of 21 assistance cases handled by the FSLIC in 1984, 13 have been categorized as asset-quality problems.

Alternative Solutions

As noted above, several of the comments to the Board's proposal also included approaches to address the capital inadequacy of thrift institutions.

1. *Case-by-Case Supervision.* A few commenters suggested that the problems addressed by the proposed regulation could best be resolved on a case-by-case basis utilizing existing or possibly expanded supervisory authority. These commenters argued that attention should be focused specifically on abusive practices and supervisory cases. The regulation was seen as unfair to those operating in a safe and sound manner. It was generally felt that growth could be controlled by increased supervisory and monitoring programs, including the possible use of monthly reporting. The Board has, in fact, taken several steps to strengthen its ability to supervise and monitor the activities of insured institutions and to modernize the examination process. Additionally, the Board developed legislation to increase its enforcement powers, which was introduced in the last Congressional session. The Board believes, however, that these efforts alone are insufficient to deal with the tremendous growth of the industry as the result of the deregulation of interest rates and broader investment powers and concomitant increased risk to the FSLIC.

2. *Limited Focus on Fast-Growing Institutions.* Some commenters suggested that the scope of the regulation should be restricted to institutions that represent a risk to the industry and, accordingly, increased net-worth requirements should apply only to institutions experiencing rapid growth. Several commenters noted that the rapid growth of the thrift industry has resulted in a decrease in public confidence in the industry and the overpricing of deposits and underpricing of mortgage loans. These practices can unfortunately have the undesirable effect of forcing otherwise conservative thrifts to match those rates or realize a loss of their market share. In response, the Board reiterates its view that all growth should be earned or supported by an adequate net-worth base, but notes that its new proposal would tailor net-worth requirements to levels of prospective liability growth.

3. *Variable-Rate Premiums.* A few commenters recommended that the Board raise the FSLIC insurance premiums or implement a variable-rate insurance premium based on risk-based insurance-premium structure in its recent legislative proposal. In order to address the immediate concerns about the inadequacy of the industry's capital base, however, the Board supports a net-worth requirement linked to growth.

4. *Modifications to Board Proposal.* One state regulator recommended that the Board increase the overall net-worth requirement to four or five percent of total liabilities and eliminate the provisions for five-year averaging and the twenty-year phase-in period. In response, the Board continues to believe at this time that a marginal net-worth requirement tied to future growth in liabilities and the gradual elimination of five-year averaging and the twenty-year phase-in period would (1) provide a sufficient capital base to protect the FSLIC insurance fund from the risks resulting from the currently deregulated environment, (2) enhance public confidence in thrifts, and (3) reduce the inequities in capital requirements between thrifts and commercial banks.

Another commenter, while endorsing the marginal net-worth concept, objected to the proposed timetable set for achieving compliance with the higher net-worth standards, characterizing them as insensitive to the restucturing efforts of the industry, the current economic condition of the industry and the possibility of rising interest rates. This commenter recommended an alternative that would retain the current net-worth requirement on existing liabilities for two years and provide for a four-percent unlimited "credit" to a new five-percent marginal net-worth requirement resulting from qualifying balances (12 CFR 563.13(b)(4)), which would be expanded to encompass additional interest-rate-sensitive assets and liabilities. Several commenters endorsed this approach, and several others suggested that the qualifying-balance deduction be increased from its current three-percent level and the items eligible for inclusion in the deduction be expanded.

Although the Board is sensitive to the concerns of the thrift industry with respect to restructuring, it continues to believe that both the risks arising from undercapitalized thrift institutions coupled with the increase in instances of failures due to credit risk and the decline in the ratio of FSLIC reserves to deposits mandate that a marginal net-worth requirement be imposed on future growth.

Several commenters suggested that the Board should not require additional net worth for growth of liabilities resulting from the crediting of interest and dividends on existing savings. These commenters stated that institutions need growth from savings to restructure their portfolios of fixed-rate loans and that any additional reserves would necessitate lowering the market rate paid on savings or increasing service charges either to prevent growth or to obtain a sufficient profit margin in order to generate the required net worth. The Board, however, maintains that any growth in liabilities regardless of the source, e.g., the crediting of interest on deposits and outstanding Federal Home Loan Bank advances, should be supported by a marginal increase in net worth.

It was also suggested that the Board exclude arbitrage transactions from the proposed minimum net-worth requirement because such transactions are fully collateralized and present an insignificant risk to the FSLIC. The Board believes, however, that a marginal net-worth requirement is necessary to safeguard institutions and the FSLIC from losses resulting from credit risk as well as interest-rate risk.

Finally, it was recommended that the net-worth requirement be based only on deposit liabilities, stating that all liabilities outside the FSLIC insurance category should be considered an enhancement to the system and provide some latitude of protection to the FSLIC. Other suggestions from commenters addressed the calculation of the reserves for scheduled items, the provision for a credit against the net-worth requirement resulting from the reduction in a thrift's losses, and the extension of the appraised-equity-capital program through 1992. The Board considered these and other alternative proposals but has determined at this time that the approach detailed in the revised proposal best serves the needs of the industry and the FSLIC.

According, after review of the comments and consideration of additional data and staff studies, the Board has determined, for the reasons set forth below, to revise the proposed rule and request further public comment.

Reasons for revising the proposal. The Board continues to be concerned that the recent rapid growth of many insured institutions has significantly reduced the capital coverage in an industry that has experienced chronic capital deficiences. Rapidly growing institutions have been able to achieve their high growth rates and still meet required capital levels in part due to the use of five-year averaging and twenty-year phase-in. For example, an institution that became an insured institution just prior to November, 1983, would be required to have net worth and statutory reserves equal to only 0.15 percent of liabilities and 0.15 percent of insured accounts, respectively. This, in effect, places no limit on the rate of growth of institutions since it permits a debt-to-equity ratio as high as 666 to 1. These factors thus enable institutions to increase significalty the risk exposure of the FSLIC without supporting the new liability base with adequate capital.

Data before the Board indicate that insured institutions are growing at a rapid rate. During the period from June 30, 1982, to June 30, 1984, retail deposits have increased 31.2 percent ($475.1 billion to $623.5 billion) and "jumbo" deposits (over $100,000) have increased 104.8 percent (from $51.3 billion to $105 billion). Other borrowings increased 90.8 percent (from $29.3 billion to $55.9 billion). As a result, total liabilities grew 36.4 percent while assets grew 36.6 percent. Since 1981, industry assets have increased from $640 billion to an estimated $947 billion at the end of October, 1984. Data also demonstrate that, at the rate of growth experienced between June, 1983, and June, 1984, the Board can expect 770 institutions, with $353 billion in assets, to double in size within the next four years.

This rapid growth has been accompanied by steady deterioration in the FSLIC reserves-to-total-deposits ratio. The current reserve ratio is approaching the range which in 1962 prompted Congress to impose a costly secondary-reserve assessment on institutions. However, in 1962, the ratio of net worth to liabilities for all insured institutions was 7.6 percent; today, the net-worth ratio is only 4.0 percent. To the extent that insured institutions' net worth provides a cushion to absorb losses prior to resorting to the FSLIC, these trends indicate the imperative need both to foster increased net worth in the thrift industry and slow the rate of growth of insured institutions in order to protect the FSLIC.

As the Board noted in its February proposal, deregulation as a result of the DIA and changes to a number of state laws also increase the FSLIC's risk exposure and increase the need for additional reserves and net worth. In the past, detailed regulation functioned as a substitute for capital. An institution's need for a significant cushion against losses was decreased because risks were limited through regulation. Deregulatory changes in recent years have significantly widened the investment powers of federal and state-chartered institutions, permitting investment in areas in which insured institutions have little experience. In some states, statutory limtis on the percentage of assets that an institution may commit to these new powers may not effectively require a prudent mix of new, riskier investments with traditional, secured investments. The industry has not yet had much experience with broadened investment authority under state law. Many of the investments made under these laws are too recent to have resulted in profit and loss. Many of the losses suffered by the industry and by the FSLIC resulted from investments that took the form of loans, but in economic reality were direct investments, and would be covered by the proposed regulation. Such investments were difficult to study statistically, because they cannot be differentiated in reports to the Board from true loans. Such investments are nonetheless responsible for the failure of a number of institutions and have resulted in significant losses to the FSLIC in recent years.

The possibility of rapid growth of deposits and other liabilities has led some institutions to embark on ill-conceived plans of asset expansion, including high-risk investments. A staff study indicates, in general, that faster-growing institutions have both riskier asset portfolios and less stable funding sources than do more slowly growing institutions. Joseph A. McKenzie, "Recent Deposit Growth and Asset Allocation of FSLIC-Insured Institutions," Federal Home Loan Bank Board, November 28, 1984. The study compares institutions that grew above the industry average of 19 percent (June, 1983, to June, 1984) to those growing more slowly than the industry average. The study demonstrates that, on the average, the faster-growing institutions have an acquisition, development and construction (ADC) loan ratio to total assets over four times that of other institutions; a construction loan ratio to total assets four times larger than other institutions; direct real estate investments as a percentage of assets six times larger; and a ratio of non-mortgage loans to total assets over one and one-half times larger than all other institutions. The study notes that these types of investments have an inherently higher degree of credit risk than residential mortgage loans and are, ultimately, a significant risk to the FSLIC. (*See* later discussion of higher-risk investment activity.)

The study further indicates that, on the average, faster-growing institutions had jumbo certificates of deposit equal to 15.25 percent of their liabilities while all others had only 5.46 percent; brokered deposits of 8.15 percent compared to 0.68 percent; and a ratio of borrowed funds to total liabilities twice that of more slowly growing institutions. These types of funds are frequently volatile and are more likely to be involved in "runs" on institutions. These funds also remove the growth constraint implied by the local retail market and thus enable the rapid acquisition of high-risk assets. Faster-growing institutions are exposed to only slightly less interest-rate risk, having a 32.8 percent six-month maturity-gap-to-total-asset ratio as opposed to 33.7 percent for all other institutions. The data also indicate that faster-growing institutions had less net worth than slow-growth institutions (4.08 percent of assets to 4.42 percent of assets) and are experiencing a faster decline in their net-worth ratio (−0.74 to −0.11).

Given that rapid-growth institutions have riskier asset portfolios, less stable sources of funds, lower net worth and experience faster deterioration of net worth, the increasing risk to the FSLIC becomes apparent. Rapid growth is also a factor in many of the past and current supervisory and problem institutions. The correlation between rapid growth and riskier investment and between rapid growth and FSLIC losses is not coincidental. Supervisory experience has shown that, in order to sustain rapid deposit growth, savings and loan management has repeatedly turned to higher-risk investments. Such investments may, at least on paper, provide higher returns that are needed in some instances to cover the cost of jumbo certificates. Faced with exponential deposit growth, institutions often lack the time or opportunity to locate sound investments, and instead make riskier investments, without proper underwriting. Staff has reviewed such individual cases in which either the institution, or ultimately the FSLIC, has experienced, or will experience, losses due to these practices. Because of these riskier investments, the FSLIC in recent years has experienced many of its largest losses from such rapid-growth institutions over $100,000,000 in size. Staff analysis has shown that the greatest percentage of the losses suffered by the FSLIC from problem institutions in 1983 and 1984 have involved rapid-growth institutions with high-risk assets. Staff studies of the recent FSILC caseload show that institutions that have growth more than 25 percent have been responsible for a disproportionate share of expected FSLIC losses. The actual losses to be suffered may be even greater because the FSLIC's experience often has been that high-risk loans or investments will not show losses on paper until long after the underlying project has gone bad, thus understating the losses incurred by the institution.

The Board is not alone in its concern regarding capital adequacy of federally-insured depositories. Subsequent to the Board's issuance of the February proposal, the federal bank regulatory agencies all issued proposed rules or guidelines to increase the minimum required capital of the entities that they regulate. Federal Deposit Insurance Corporation, 49 FR 29399 (July 20, 1984); the Board of Governors of the Federal Reserve System, 49 FR 30317 (July 30, 1984); and Office of the Comptroller of the Currency, 49 FR 34838 (September 4, 1984). These agencies collectively regulate commercial banks that, as noted above, are growing at a slower rate than thrift institutions regulated by the Board. The effect of these proposals, in summary, would be to require a minimum "primary" capital of 5.5 percent of assets and total capital of 6.0 percent for banks and bank holding companies that are well-managed and have no material weakness. All three agencies recognized the important function of capital in the industries they regulate to absorb fluctuations in income, to bolster public confidence in individual entities and in the system as a whole, to support growth while restraining imprudent expansion, and to provide protection to depositors in the event of a threatened insolvency. These agencies noted that the maintenance of stability of the financial system and protection of depositors are critical to their regulatory mission and acknowledged that capital adequacy plays a key role in their programs.

Description of the Revised Proposal

"Statutory reserve" test. Like the February proposal, the revision also proposes eliminating the "statutory reserve" test of 12 CFR 563.13(a). The Board believes that the minimum net-worth standard is a more reliable gauge of capital adequacy because it is calculated upon total liabilities, not merely insured deposits. The DIA amendment indicates that Congress no longer intends to restrict the Board to imposing a capital adequacy standard based upon insured deposits. Therefore, the Board continues to propose to make compliance with the minimum net-worth requirement sufficient for compliance with the reserve requirement of section 403(b) NHA. State requirements tied to the reserve requirement of section 403(b) would be met by compliance with the proposed net-worth requirement.

Calculation period. The revised proposal would significantly change the time in which insured institutions must calculate and meet the minimum net-worth requirement. The current regulation requires the establishment of the net-worth requirement as of the opening of business of the first day of each fiscal year and allows insured institutions to wait until the end of that fiscal year to meet the requirement. 12 CFR 563.12(b)(1) (1984). The effect of this significant lag has been to permit institutions to operate a full year without sufficient net worth before the Board could take enforcement and supervisory action to correct the deficiency. The current lack of supervisory constraints on growth has permitted small problem institutions to become large problems. When an institution can grow by 300 percent in a year, losses to the FSLIC can grow by the same factor. In addition, growth at that rate not only makes it difficult for an institution to locate prudent investments, it also makes it difficult, if not impossible, to examine and supervise institutions adequately. Examination occurs, by necessity, after the fact. When growth is not controlled, problem assets may grow exponentially between examinations. The damage is done before any supervisory action can be taken.

The February proposal did not address these problems. The Board is revising that proposal to change the calculation period in two ways. First, institutions would be required to calculate their minimum net worth as of the end of each calendar quarter. This would provide management with significantly more current, and therefore more useful, information throughout the year. This change would also bring the net-worth calculation in line with the Board's quarterly reporting program, thus providing the Board with better ability to monitor and, where necessary, take appropriate supervisory action. Secondly, the revision would require insured institutions to meet the minimum net-worth requirement on the date it is required to be calculated. This will eliminate the lag and thereby increase the Board's ability to respond quickly and to take appropriate action before an institution's condition deteriorates further. The Board is proposing to eliminate this lag in recognition of management's responsibility to plan an institution's growth and the technical methodologies that have become available to assist management in such planning.

Computation of the minimum net-worth requirement. The proposed revision would use a combination of "factors" in place of the algebraic expression used in the February proposal to calculate the net-worth requirement. The minimum net-worth requirement would be comprised of a "base factor" (essentially the dollar amount of the minimum net-worth requirement as of the last calculation); an "amortization factor" (by which five-year averaging and twenty-year phase-in would be eliminated); a "growth factor" (which would vary the marginal increase in the minimum net-worth requirement in a manner dependent upon the amount of liability growth); and a "contingency factor" (including the current requirements of 2 percent of recourse liabilities and 20 percent of scheduled items plus an amount equal to 10 percent of direct investments). The Board is not proposing to alter the calculation or use of the "qualifying balance deduction or "appraised equity capital" currently permitted by 12 CFR 563.12(b)(4) and (c) (1984). The only proposed change in the treatment of *de novo* institutions would be to require them to use the calculation period proposed in the revision and to use all of the "factors" to determine their minimum net-worth requirement after their "phase-down" is completed.

Five-year averaging and twenty-year phase-in. The revised proposal would eliminate five-year averaging and twenty-year phase-in, for the reasons stated earlier, but by a method different than that set forth in the February proposal. The February proposal would gradually eliminate five-year averaging by reducing the number of fiscal years which could be averaged each year over a five-year period. The twenty-year phase-in would be gradually eliminated by permitting qualified institutions to apply this procedure only to pre-December 31, 1983, levels of liabilities after that date multiplied by three percent. Once all institutions insured prior to November 3, 1983, have reached the twentieth anniversary of insurance of accounts, the phase-in would be entirely eliminated.

"Amortization factor". Under the new proposal, both factors would be eliminated by using a straight-line amortization method over a five-year period. An insured institution would be required to calculate the amount of minimum required net worth as of December 31, 1984, by multiplying its total liabilities by 3 percent. It would then calculate the minimum required net worth as of that date using the five-year averaging and twenty-year phase-in method, if appropriate. The difference between these calculations (referred to as the "amortization factor") would be amortized over five years by adding one-twentieth of that amount to its minimum net-worth requirement each quarter.

The Board believes that this method is operationally easier for institutions to use than the method set forth in the February proposal. The revised method requires an institution to calculate the amortization factor only once, rather than requiring different calculations each year. Board research indicates that the revised method will have either virtually the same impact or will impose a lower requirement than the February proposal for 2,629 institutions in the first year, but impose a higher requirement for 480; equal or lower for 1,947 institutions in the second year, but higher for 1,162; equal or lower for 1,407 institutions in the third year, but higher for 1,702; equal or lower for 1,536 institutions in the fourth year, but higher for 1,573; and equal or lower for 2,554 institutions the last year, but higher for 555. The major impact of the change from the February proposal is that the twenty-year phase-in method would be eliminated in five years, rather than continuing to be applied to the level of pre-December 31, 1983, liabilities by institutions until they reach the twentieth anniversary of insurance of accounts by the FSLIC. To the extent that the twenty-year phase-in method contributes to the ability of institutions to expand rapidly both their liabilities and the potential risks to the FSLIC, the Board believes that this change is an improvement over the February proposal.

Marginal growth. The proposed revision would also change the method by which marginal growth in liabilities is considered when determining the minimum net-worth requirement. The February proposal would require all institutions (other than *de novo* institutions) to multiply increases in liabilities between December 31, 1983, and the date of calculation by 3 percent. Institutions experiencing no growth in liabilities or experiencing a decrease in liabilities after December 31, 1983, would not be affected. Studies prepared for the Board demonstrate, however, a greater need to restrain rapid levels of growth.

Rapid growth is not necessary for an institution to restructure its portfolio. Current information indicates that at a moderate growth rate of 15 percent per year an institution (having an asset composition based upon the June 30, 1984, industry aggregates) can within five years decrease its percentage of fixed-rate mortgage loans from 56 percent of assets to 17 percent, by reinvesting both new funds and cash flows from existing assets in interest-rate sensitive assets. In fact, an institution could reduce its fixed-rate mortgage loans from 56 percent of assets to 33 percent in 5 years without any growth in liabilities, merely by funding new interest-rate sensitive assets with the cash-flows from principal repayments on existing assets. This demonstrates that liability growth is not essential to restructuring.

As described above, Board studies indicate that institutions growing at annual rates in excess of 19 percent have both riskier portfolios and less stable funding sources. The fixed-rate, marginal net-worth requirement in the February proposal does not take into account differences resulting from faster rates of growth. However, a minimum net-worth requirement tied to a variable rate based on an institution's growth rate would better reflect (1) the capital requirements appropriate for such growth, and (2) the risks posed to the FSLIC by excessive growth. This approach would also permit each institution to determine its own level of marginal net worth by controlling its rate of growth.

"Growth factor". Based on the foregoing considerations, the revision proposes to require an institution to add to its "base factor" a "growth factor" corresponding to a varying percentage of the growth in liabilities that occurred during the quarter. The percentage would be determined by the rate of growth from the corresponding quarter of the preceding year. Using this measure for determining the growth rate should make allowances for seasonal variations in growth. An institution growing at an annual rate of 15 percent or less since the corresponding quarter of the preceding year would be required to add a "growth factor" in an amount equal to 3 percent of the increase in liabilities during the quarter for which the minimum net-worth requirement is being calculated; an institution growing from the corresponding quarter of the preceding year at an annual rate between 15 and 25 percent would add 4 percent of that quarter's increase in liabilities; and an institution growing in excess of 25 percent from the corresponding quarter of the preceding year would be required to add to its minimum net-worth requirement an amount equal to 5 percent of the growth during the quarter. However, to avoid the impact of growth made prior to this proposal, growth during calendar year 1985 would be measured from January 1, 1985.

This proposal (as well as the February proposal) does not necessarily require institutions to increase the amount of net worth that they hold. Institutions having net worth in excess of the minimum requirement can use that excess to offset any increased minimum requirement resulting from liability growth. Approximately 73 percent of insured institutions already hold net worth equal to at least 3 percent of their liabilities and 55 percent have net worth in excess of 4 percent of their liabilities. Thus, most institutions already hold enough net worth to enable them to grow at a rate below 15 percent and comply with the proposed revision.

Mutual institutions will not be significantly affected by the change in approach from the February proposal because on the average, mutual institutions have grown less than 15 percent from June, 1983, to June, 1984. (Mutual institutions with less than 3 percent net worth grew at 16 percent and those with more than 3 percent grew at 11 percent.) Stock institutions have grown on the average at excessively greater rates (approximately 50 percent for those with less than 3-percent net worth and 60 percent for those with greater than 3-percent net worth). Thus, most mutual institutions would be required to increase their minimum net-worth requirement at a 3-percent marginal rate similar to that of the February proposal, while most stock institutions would be required to increase their minimum net-worth requirement by 5 percent of the increase in liabilities. This resulting difference in treatment is not inappropriate given the greater average rate of growth of stock institutions, their easier access to capital markets, and the fact that stock institutions tend to have more net worth in excess of 5 percent of liabilities than do mutual institutions (and can thus absorb increases better without going to the capital markets).

The proposed revision contains two refinements not included in the marginal net-worth requirement of the February proposal. First, an institution that decreases its liabilities during a calendar quarter would be permitted to decrease its required minimum net worth. The decrease would be multiplied by a factor equal to the institution's previous minimum net-worth ratio (i.e. its "base factor" divided by its total liabilities). This amount would be the "growth factor" to be deducted from the base factor when computing the net-worth requirement for the quarter in which the decrease occurred. While the minimum net-worth ratio would stay the same, the dollar amount of required net worth would decrease in a manner corresponding to the decrease in liabilities. The February proposal did not provide for a decrease and thus would have penalized institutions that reduced their liabilities.

Second, the revised proposal addresses the issue of the effect of mergers, acquisitions, purchases of assets and liabilities, and consolidations (collectively referred to as "combinations"). The revised proposal would treat all such combinations as if they were a pooling of interests in which the resulting institution's net worth and liabilities are equal to the combined net worth and liabilities of the two institutions. Combinations accomplished through purchase accounting would be recalculated on a pooling-of-interest basis for the purpose of determining the minimum net-worth requirement. Any increase in liabilities resulting from a combination would not be included as a quarterly increase in the calculation of the "growth factor". This approach would avoid discouraging institutions from undertaking such combinations.

Exception for small institutions. The revised proposal would provide an exception to the net-worth computation, described above, for any institution that, at the end of a calendar quarter, has $100,000,000 or less in total assets and that has grown (from the corresponding calendar quarter of the preceding year) at an annual rate not exceeding 15 percent. These institutions would not be required to compute the "base factor", the "growth factor", and the "amortization factor" that would be computed by institutions not qualifying for the exception. Institutions qualifying for the exception would be permitted to continue using five-year averaging (although calculated on a quarterly basis), but would not be permitted to continue using the twenty-year phase-in. The average of amount of liabilities at the end of the calendar quarter and on the corresponding calendar quarter(s) of one or more of the four immediately preceding fiscal years (provided all such dates were consecutive) would be multiplied by 3 percent. This does not permit twenty-year phase-in and, but for the effect of five-year averaging, requires the same percentage of liabilities on the margin that would be required by an annual rate of growth of 15 percent or less. Since the use of the twenty-year phase-in would be discontinued for both qualifying and non-qualifying institutions, it is appropriate to amortize the effect of this change in the same manner. Thus, an "amortization factor" would be added, equal of 1/20th of the difference between calculating the net-worth requirement as of December 31, 1984, with the use of both five-year averaging and twenty-year phase-in, and calculating the requirement on that date using only five-year averaging. The "contingency factor" would also apply to institutions qualifying for the exception and would be added to compute the minimum net-worth requirement. If an institution grows at an annual rate exceeding 15 percent, it would not qualify for the exception and would use the general computation rule. If in a subsequent quarter the institution's growth rate permitted it to qualify for this exception, it could resume using five-year averaging. Similarly, if an institution decreased its assets to an amount below $100,000,000, it could qualify for this exception (assuming it did not exceed the stated growth rate) even if in any previous quarter it had more than $100,000,000 in assets. The Board requests commenits on the appropriateness of permitting small institutions to leave and then re-enter this exception. Mergers would effectively be treated in the same manner as mergers involving large institutions, by using pooling-of-interest accounting in determining the minimum net-worth requirement.

The Board recognizes that relatively higher rates of growth by small institutions may be necessary to permit them to achieve operational efficiency. Studies show that economies of scale exist over a broad range of asset sizes. The most dramatic improvement in operating efficiencies accrues to growth of smaller institutions. Data indicate a slower improvement in operating efficiency once an institution reaches an asset size between $40,000,000 and $60,000,000. Given this data, and to take into consideration future inflation, the Board believes it is appropriate to except institutions whose assets are $10,000,000 or less. This would exclude 55 percent of all insured institutions. The exception, however, would not exclude institutions having approximately 91.6 percent of the assets in the industry, and would therefore provide an effective mechanism for supervising those institutions presenting the greatest potential risk to the FSLIC.

"Contingency factor". As did the February proposal, the revised proposal would continue the current requirement that the minimum net worth of an insured institution also includes amounts equal to 2 percent of recourse liabilities and 20 percent of scheduled items. This requirement acts, in effect, as a reserve for contingencies (i.e. the possible required repurchase of loans sold with recourse and the possible losses from loans currently categorized as "slow" loans). The revised proposal combines these elements of the net-worth requirement into a "contingency factor" which would be determined quarterly and added along with the other factors. The contingency factor, unlike the growth factor, is not intended as a marginal requirement. Thus, when determining the "base factor" for the next quarter's requirement, the contingency factor of the preceding quarter is excluded and is, instead, recalculated and added to the base factor at the end of the new quarter.

Direct investment "contingency factor". The revised proposal would add a third component to the two existing parts of the contingency factor. This component would be an amount equal to 10 percent of the amount that an institution has invested in certain real estate, service corporation and equity securities, referred to collectively as "direct investments". The Board has proposed to regulate insured institutions' direct investments (Board Res. No. 84–227, 49 FR 20719, (May 10, 1984)), and the Board notes that a number of commenters on that proposal took issue with the connection posited between such investments and increased risk to the FSLIC. While the specific points raised by those comments will be addressed in connection with that rulemaking, research conducted for the Board clearly indicates the risks associated with direct investments.

For several months, the Board has engaged in considerable research to evaluate the nature of the risk of direct investment to the FSLIC and to determine whether an additional net-worth requirement is appropriate. The research suggests that returns from direct investments and service corporations are inherently more variable than most other forms of investment undertaken by thrift institutions, and that allowing such institutions to engage in unlimited amounts of direct investment could result in those institutions taking on unacceptably large levels of risk without adequate reserves and thereby posing a threat of substantially increasing losses to the FSLIC.

Board staff conducted an extensive examination of the economic and financial literature on rates of return and risk levels for various general asset categories (see *Examining Historical Returns and Risk for Debt and Equity Assets*, Office of Policy and Economic Research, 1984). The examined studies measured both rates of return and economic risks for real estate, common stocks, government and corporate bonds, and Treasury bills. These studies clearly show that equity investments such as common stocks are riskier investments than debt securities when variation in return is used as a measure of risk. The risk posed by real estate investment reflected a less solid consensus, with some studies indicating that the returns to real estate are riskier than both common stock and debt securities, others showing real estate is less risky than stocks but riskier than debt, and still others finding real estate to be less risky than either stocks or bonds.

The overall conclusion of Board staff is that the findings of these studies, when applied to actual situations where thrift associations possess different levels of competence and face different investment decisions, suggest that real estate investment will prove generally riskier than straight debt obligations. The studies surveyed implicitly assumed a geographically diversified real estate portfolio, since they used national data. In most cases, however, insured institutions are unlikely to be able to achieve complete geographic diversification. Relatively few institutions have interstate branch and lending networks, and thus the area they know best is relatively compact. Although attempts at geographic diversification can be made through joint ventures, this will often involve dealing with new and unknown partners in areas outside the institution's normal lending territory. Moreover, participations in such joint ventures can expose institutions to huge partnership liability that is totally disproportionate to the potential returns from the joint ventures. Finally, most real estate development occurs in fast-growing areas, and such areas can be prone to speculative over-building and resulting losses to developers.

It is not surprising that most economic and financial studies suggest that equity investments over a long period of time will prove riskier than debt investments. Claims of equity investors on the assets underlying their investments are generally subordinate to those of all other claimants. This implies that equity investors share disproportionately in both the losses and profits realized on the assets underlying investments. In contrast, the investor in debt obligations receives payments of interest on principal even after an equity investor's claim on cash flow has reached the zero level. Not surprisingly, average returns on equity investment are higher than those on debt investment because in a market of risk-averse investors there will be a positive trade-off between return and risk. Generally, economic and financial studies confirm the theoretical premise that investors may only obtain a higher expected rate of return by incurring additional risks. Investors also require a higher expected rate of return to incur additional risk. The staff has reviewed decisions by federal rate-making bodies and found that they consistently provide for substantially greater returns for equity versus debt because they have found that equity investments are substantially riskier than debt.

Another study by Board staff examined rates of return and the variability of savings institution investments in service corporations between 1979 and 1983 (see *Rates of Return from S&L Investments in Service Corporations, 1979-1983*, Donald G. Edwards, Office of Policy and Economic Research, 1984). Because service corporation data are reasonable proxies for the rates of return and the variance of rates of return on direct real estate investment by thrifts and are available to both Board staff and other researchers, the study used data from investments in service corporations to measure returns on direct investment. Data from over 1,000 institutions with investments in service corporations during the period 1979–83 were analyzed to obtain estimates of returns and variability of returns from these investments. Sample institutions were selected on the basis of consistent reporting of service corporation investment and net income in their semiannual reports of condition to the Board.

The rates of return reported by the sample institutions were found to have a mean of 17.4 percent over the period 1979 to 1983. The distribution of returns was extremely wide, with many associations reporting either large losses or large profits on their investments. The estimated median rate of return for the period 1979–83 was only 8.9 percent. The large difference between the mean rate of return and the median, coupled with the wide distribution of returns, demonstrates the general conclusion that savings institutions realized both high average rates of return and high average degrees of risk with investments in service corporations.

The distribution of rates of return reported by the sample of associations indicates that many investments performed very poorly. In the 1979–83 sample, 13 percent reported negative returns, 54 percent reported returns below the industry's average cost of funds (9.71 percent) for the period, and 67 percent reported returns below the industry's average interest rate on conventional single-family mortgage loans closed (13.35 percent). This large dispersion of service corporation returns, coupled with the high mean rate of return, suggest that the Board is correct in proposing to require an additional reserve requirement for institutions engaging in these riskier direct investments.

Another Board staff study analyzed how different hypothetical portfolios—consisting of fixed-rate mortgages, adjustable-rate mortgages, commercial loans, common stocks, and real estate—would have performed under the actual market conditions existing over the period 1978 to mid-1984. (See *Deriving a Thrift Institution's Efficient Frontiers in Constrained and Unconstrained Environments*, G. Stacy Sirmans, Office of Policy and Economic Research, 1984). The study concluded that, in general, while savings institutions could have increased their average expected return by increasing direct investments, this would also have entailed a major increase in the level of total portfolio risk for a broad range of portfolios.[1]

[1] The study found that fixed-rate mortgages behaved quite poorly during the same period, but also confirmed that well structured adjustable-rate mortgages would have performed very well. The relevant comparison, of course, is at the *margin*; e.g., would it be riskier for an association to invest its funds in direct investments, adjustable-rate mortgages, or other loans. The studies confirm the

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While these conclusions must be examined with the restraint appropriate to any conclusion drawn from a hypothetical economic study, they clearly suggest that a required reserve for direct investment is a reasonable protection against additional risk.

In order to address the effect that different forms of investment may have on the total risk of an institution's portfolio, a Board survey examined the correlation coefficients between various equity and debt investments. The results generally show that the correlations between different forms of equity and different forms of debt are either positive or only moderately negative.

A further Board study (see *An Analysis of Service Corporation Investment and Direct Real Estate Investment by FSLIC-Insured Savings Institutions*, Joseph A. McKenzie, Office of Policy and Economic Research, 1984), based on June 30, 1984, data indicates that institutions with significant service corporation and/or direct real estate investment are growing far more rapidly, have asset portfolios with significantly more potential credit risk, have liability structures that are potentially less stable, and originate significantly lower proportions of permanent 1- to 4-family home mortgages than the average savings institution.

Forty-seven of the 2,953 institutions (all having assets of $10,000,000 or more as of June 30, 1983) in this study had combined direct investment of 10 percent or more of assets. Those 47 institutions had an average 181 percent asset growth for the year ending June 30, 1984, compared with a 21 percent growth rate for institutions with combined direct investment of less than 10 percent. Because it is in general very difficult to evaluate adequately investments that grow at such high annual rates, this dramatic disparity in growth rates between savings institutions with direct investment above and below 10 percent indicates that those heavily involved in direct investment, at least on average, are hardly risk-minimizers. Compared with the group with combined investment of less than 10 percent of assets, the 47 institutions also had, on average, significantly higher ratios to assets of acquisition, development, and construction loans, traditional construction loans, and nonresidential mortgages. The Board's supervisory experience is that these asset categories traditionally have a significantly higher demonstrated credit risk than residential mortgage lending. Institutions with a combined direct investment of 10 percent or more of assets also exhibit significantly greater reliance on jumbo certificates than the group with combined direct investment of less than 10 percent. As recent events have shown, deposits of more than $100,000 can prove extremely unstable when a financial institution confronts problems that are publicly recognized.

The Board's supervisory experience confirms these theoretical and empirical demonstrations of the relatively riskier nature of direct investment. Severe losses have occurred, or will occur, in many institutions that have invested most heavily in direct investments (including investments that are, in economic reality, direct investments even though recorded as purported loans). Moreover, available data may seriously understate losses that have already occurred as a result of direct investments. Losses resulting from poor asset quality do not automatically appear on institutions' books. A loss may not be realized until the examiner has ordered a reappraisal of the asset. Examiners may have difficulty in identifying problem assets, particularly if they are investments such as ADC loans, which may take the form of loans but in economic reality are direct investments that would, under the proposed regulation, require a 10 percent reserve. These "loans" will appear current on an association's books only because the institution has funded reserves for the payment of interest. Often, the "loan" amount also funded high loan fees, further boosting the institution's balance sheet. These factors, however, distinguish direct investments from scheduled items that can be more readily identified as potential losses due to the actual performance of the loans.

A 1982 Board study (that evaluated the asset investment powers of Texas thrifts in connection with the Board's request that Congress broaden the powers of federally chartered thrifts) found that the state chartered thrifts had substantially higher average net returns on investments made through their broadened asset powers than they did on their conventional mortgage portfolios. These broadened asset powers included commercial and personal loans and direct investments. The study also found that the pre-tax return on assets for Texas state-chartered stock institutions was significantly higher than for federally chartered mutual institutions (see *The Contribution of New Asset Powers to S&L Earnings: A Comparison of Federal- and State-Chartered Associations in Texas*, Research Working Paper No. 110, Office of Policy and Economic Research, July 1982).

There have been suggestions that this 1982 study demonstrated that direct investments were no riskier than other investments. In fact, that study did not examine direct investments, but rather included the entire package of new equity *and debt* investment powers granted by Texas. Moreover, the study did not examine the *risk* posed by direct real estate investments. The study confirmed only what is widely known and accepted—that the package of new asset powers can yield higher *average* returns than traditional investments—but did not deal with the issue of the *riskiness* of these investments, and the possible consequences of that riskiness for both institutions themselves and the FSLIC. During 1981, the time period over which the study's data are derived, the average ratio of direct investment to assets in Texas chartered thrifts was 0.56 percent and the maximum was 7.97 percent. Given the context in which the study was conducted—a period in which direct investment accounted for relatively miniscule percentages of most institution assets—it is not surprising that the study did not evaluate this risk.

While the study did note that direct real estate investment had a higher return than the *historical* mortgage portfolio, it also noted that the appropriate comparison would have been between the returns on direct real estate investment and returns associated with new mortgage lending. A comparison was not made in the study itself. Using this more appropriate comparison, the yield advantage of direct real estate would have proven far smaller. The authors of this study understood this limitation, and acknowledged it by pointing out that "because mortgages have longer maturities than other assets, during a period of rising interest rates, the average mortgage yield is likely to be further below market rates that the average yield * * * and yields on new conventional mortgages would probably be closer to the yield on alternative assets."

An argument has been made that direct investments in real estate and equity securities are short-term assets and therefore provide a good "match" with liabilities of thrift institutions. The entire notion of assets/liability matching rests on the principle that a "good match" results when the fluctuations in the rate paid on a liability closely follow the fluctuations in the return on the

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rationality of the thrift industry making over 70 percent of new mortgages in the form of adjustable-rate mortgages.

asset that the liability is funding. Adjustable-rate mortgages provide an excellent match for thrift institution deposits since both rates paid and rates received tend to follow closely in tandem Conversely, as the Board's studies cited above have shown, there is no reason to expect a close correlation between the cost of institution deposits and the returns received from any particular form of direct investment. The large distribution of service corporation rates of return demonstrates conclusively that funding direct investments through savings deposits results in an extremely poor asset/liability match. If anything, a need for close asset/liability matching by thrift institutions argues strongly in favor of requiring additional net worth for institutions engaging in greater direct investments.

Given the risk of these investments, a direct investment component of the contingency factor similar to those for recourse liabilities and scheduled items is appropriate. The traditional activities of insured institutions have consisted primarily of secured lending (such as home mortgage loans), in which the security property is appraised and the amount of the loan is limited in accordance with the value of the property, thus providing a cushion in the event of losses from default. Contingency "reserves," however, have been required for scheduled items and recourse liabilities because they provide an additional offset for potential losses. It is thus appropriate to provide an additional cushion for these riskier direct investment activities that often are not secured and that do not provide institutions with a cushion similar to that provided by traditional investments.

The substantially greater risk of loss posed by direct investment supports a greater net-worth requirement. For scheduled items, however, there is specific information that a particular asset is performing badly and may default. No such specific information is available at the *outset* in making a direct investment. Thus, while some reserve is appropriate, the Board believes that the percentage should be less than the percentage required for scheduled items. Therefore, the revised proposal would require the "contingency factor" to include an amount equal to 10 percent of direct investments. The Board requests comments on the appropriateness of this level of reserves.

The direct-investment contingency factor references definitions of three components of direct investment contained in the proposed regulation on direct investments. The Board intends to clarify those definitions for purposes of the revised net-worth proposal.

Proposed § 563.9–8(f)(2) (49 FR 20719) defines an "investment in real estate" to mean the direct or indirect ownership of an equity interest in real property (other than office buildings and foreclosures) as determined in accordance with generally accepted accounting principles ("GAAP"). The Board has since proposed standards reflecting GAAP for classifying real estate investment and for reporting them in financial statements. *See* 49 FR 43557 (October 30, 1984). If these standards are not adopted in final form, it is the Board's intention that for the purposes of the net-worth proposal, each institution should determine whether particular real estate investment constitutes an equity interest in real estate in accordance with GAAP. The Board notes that the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants has published a notice to practitioners that sets forth certain characteristics for an auditor to consider in evaluating the institution's determination. *See Journal of Accountancy* 51 (November 1983).

The Board wishes to clarify that investments of institutions in finance subsidiaries pursuant to § 545.82 of the Board's Federal Regulations are not intended to constitute "direct investment" for purposes of proposed § 563.9–8, and thus would not constitute direct investments for purposes of the revised net-worth proposal. The Board declared the inapplicability of the direct investment threshholds to investments made by institutions in finance subsidiaries in the preamble to its final rule regarding finance subsidiaries of federal associations. Board Resolution No. 84–369, 49 FR 29357 (July 19, 1984).

Proposed § 563.9–8(g)(1) (49 FR 20719) defines "equity security" broadly to include, among other things, any interest or instrument commonly known as an equity security or a certificate of interest or participation in any profit-sharing agreement, as well as any warrant or right to subscribe for or purchase any such security, and any debt security convertible into any such security. Enumerated securities, including equity securities issued by a service corporation, were excluded from the definition. The Board believes that equity securities issued by an institution's own finance subsidiaries, as defined in 49 FR 29357 (July 19, 1984), should be excluded from the definition for purposes of the reproposed net-worth rule. The Board is not persuaded, however, that further narrowing the definition would be productive of the ends sought by the reproposed net-worth regulation. Specifically, concerns regarding the safety and soundness of insured institutions would not be alleviated by excluding from the definition of "equity security" investments in limited partnerships or joint ventures, equity securities acquired in "foreclosure" situations, investments in closed-end investment companies, or Sallie Mae securities. Convertible securities would be deemed to be "equity securities" if accounted for as such under GAAP.

In order to avoid "double reserves" on investments in service corporations when an institution is consolidated with its service corporation, the revised proposal would permit an institution to exclude the amount of its investment in the service corporation from the total amount of direct investments in calculating the contingency factor. However, once consolidated, any direct investment made by the service corporation would be included in the total amount of direct investments made by its parent institution.

Approval for growth in excess of 25 percent. Finally, to address more effectively the Board's concern with excessive growth by insured institutions, discussed above, the Board is proposing to require institutions to obtain prior written approval from the appropriate Principal Supervisory Agent before growing at an annualized rate in excess of 25 percent per quarter. As stated previously, the Board's research demonstrates that institutions that have increased their liabilities by an annual rate of more than 19 percent have significantly riskier asset portfolios and less stable funding sources than institutions growing at a lesser rate. For the reasons set forth in the above discussion of the exception for small institutions, the Board believes that it is appropriate to exempt institutions whose assets are $100,000,000 or less from the prior-approval requirement.

Institutions to which the prior-approval requirement would apply would submit information necessary for the Principal Supervisory Agent to determine the institution's ability to manage the resulting increase in activities, to determine the stability of the funding sources and the risks of potential runs, and the interest-rate and credit risks posed by the planned uses of the funds. This would also ensure that the management of an institution carefully considers the potential impact of various marketing practices such as (1) paying a fee to a third party for marketing, underwriting or soliciting liabilities; (2) utilizing a listing service to make its rates known in any market for liabilities; (3) engaging in marketing practices including off-site media advertising and direct or indirect solicitation by employees of the institution by mail, telephone, or other means; or (4) utilizing the services of, or marketing deposits through, a deposit broker.

Sunset provision. The Board intends to examine the issues presented by the implementation of this proposal, if adopted as a final rule. The Board is therefore proposing that the revision, if adopted as a final rule, would expire on January 1, 1987, unless further action is taken by the Board prior to that date.

Studies and data cited in the preamble are available for public inspection along with comments received on the proposal.

Initial Regulatory Flexibility Analysis

Pursuant to section 3 of the Regulatory Flexibility Act, Pub. L. 96–354, 94 Stat. 1164 (1980), the Board is providing the following regulatory flexibility analysis.

1. *Reasons, objectives and legal basis underlying the proposed rule.* These elements are incorporated above in the supplementary information regarding the proposal.

2. *Small entities to which the proposed rule would apply.* The proposed rule would apply to institutions whose accounts are insured by the FSLIC, except that institutions whose assets do not exceed $100,000,000 and which increased liabilities by 15 percent or less would not be required to eliminate the use of five-year averaging. Also, the prior-approval requirement for institutions to increase liabilities in excess of 25 percent would not apply to institutions having $100,000,000 or less in assets.

3. *Impact of the proposed rule on small institutions.* The proposed rule would limit the leveraging ability of rapidly growing small institutions by imposing a variable, marginal net-worth requirement on any quarterly increase in liabilities and by gradually eliminating five-year averaging and twenty-year phase-in in the calculation of minimum net-worth requirements. An exception, however, would permit those small institutions that increase their liabilities by 15 percent or less to continue to use five-year averaging.

4. *Overlapping or conflicting federal rules.* There are no known federal rules that duplicate, overlap, or conflict with this proposal.

5. *Alternatives to the proposed rules.* There are no alternatives to the elimination of techniques that understate the capital adequacy of small institutions that would be less burdensome than the proposal in addressing the concerns expressed in the supplementary information set forth above.

The Board has determined to provide less than a 60-day comment period (with comments due by December 31, 1984) because (1) this is a reproposal in which a number of issues were addressed, and comments received, in the February proposal, and (2) the need to avoid undue disruption of institutions' financial planning for fiscal year 1985. Further, the Board advises that, should the amendments be adopted in substantially the form proposed herein, it is the Board's intention that they take effect for the calendar quarter beginning January 1, 1985.

Lists of Subjects

12 CFR Parts 561 and 563

Insurance of accounts; Savings and loan associations.

12 CFR Part 570

Savings and loan associations.

12 CFR Part 571

Accounting, Bank deposit insurance, Savings and loan associations.

12 CFR Part 584

Holding companies, Savings and loan associations.

Accordingly, the Federal Home Loan Bank Board hereby proposes to amend Parts 561 and 563, Subchapter D, Chapter V of title 12, Code of Federal Regulations, as set forth below.

SUBCHAPTER D—FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

PART 561—DEFINITIONS

§ 561.13 [Amended]

1. Amend § 561.13(a) by removing the phrase "statutory-reserve or"; and amend § 561.13(c) by changing "§ 563.13(c)" to read "§ 563.13(d)". [If § 561.13 is amended as proposed by Board Resolution No. 84–680, then § 561.13(c) will become § 561.13(d) and will be amended accordingly.]

PART 563—OPERATIONS

§ 563.7-4 [Amended]

2. Amend § 563.7–4(l)(2)(iv) and (v) by removing the phrase "statutory-reserve requirement or".

§ 563.8-1 [Amended]

3. Amend § 563.8–1(d)(1)(iv) by removing the phrase "or Federal insurance reserve".

4. Amend § 563.13 by revising paragraph (a); by redesignating paragraph (b)(4) as paragraph (b)(5); by revising paragraphs (b)(1), (2) and (3), and adding new paragraph (b)(4); by removing paragraph (f); by redesignating paragraphs (c), (d), and (e) as paragraphs (d), (e) and (f), respectively; by adding new paragraph (c); by removing the phrase "reserve requirements of paragraphs (a) and (b)" in the first sentence of new paragraph (d)(1) and substituting the phrase "requirement of paragraph (b)"; by removing the phrase "*statutory reserve or*" in the heading of new paragraph (e); by removing the phrase "the statutory reserve requirement set forth in paragraph (a) of this section or" in the first sentence of new paragraph (e), by removing the phrase "paragraph (b)(2) of this section or the statutory reserve requirement set out in paragraph (a)(2) of this section" from the first sentence of new paragraph (f) and substituting the phrase "paragraph (b) of this section"; by revising paragraph (g); and by adding new paragraphs (h) and (i); as follows:

§ 563.13 Regulatory net-worth requirement.

(a) *Scope.* (1) This section sets forth the requirements for the maintenance of regulatory net worth by all insured institutions. Compliance with the requirements of this section shall be considered to be compliance with the reserve requirements of section 403(b) of the National Housing Act (12 U.S.C. 1726(b)).

(2) Items previously credited to the predecessor Federal Insurance Reserve Account shall be designated "restricted retained earnings" in the list of items comprising the net-worth account, and shall be used only for absorption of losses. Items earmarked or otherwise designated but not credited to that Account may be designated as restricted retained earnings.

(b) *Minimum required amount*—(1) *General rule.* Except as provided in paragraphs (b)(2) and (3) of this section, the minimum net-worth requirement for any calendar quarter shall be the sum of the following:

(i) The base factor;

(ii) 1/20 of the amortization factor as defined in paragraph (h)(5)(i) of this section;

(iii) The growth factor; and

(iv) The contingency factor.

(2) *Exception for de novo institutions.* (i) *De novo* institutions shall have a minimum net worth equal to the sum of the contingency factor plus seven percent of all liabilities of the institution, which shall decline by 100 basis points for each year following the beginning of the first full fiscal year until equal to five percent; thereafter, upon the approval of

the Principal Supervisory Agent pursuant to paragraph (b)(2)(iii) of this section, the minimum net worth shall be equal to the amount specified by paragraph (b)(1) of this section.

(ii) *De novo* institutions which elect to have their applications for insurance of accounts processed in accordance with the policy set forth in § 571.6(a)(2) of this subchapter but which do not additionally qualify under § 571.6(a)(3), shall have, for the period between the commencement of operations and the beginning of the first full fiscal year and for three years following the beginning of the first full fiscal year, a minimum net worth equal to the sum of the contingency factor plus seven percent of all liabilities; thereafter, upon the approval of the Principal Supervisory Agent pursuant to paragraph (b)(2)(iii) of this section, the minimum net worth shall equal the amount specified by paragraph (b)(1) of this section.

(iii) The Principal Supervisory Agent of the institution's Federal Home Loan Bank district has delegated authority to approve a change in the minimum net-worth requirement for a *de novo* institution from the amount specified by paragraph (b)(2) of this section to the amount specified by paragraph (b)(1) of this section: *Provided*, that the Agent does not take supervisory objection to the probable effect of such reduction on the institution's safe and sound operating condition. If approval is withheld, the institution may seek review and final decision by the Corporation.

(3) *Exception for institutions with not more than $100,000,000 in assets*. Except as provided in paragraph (b)(2) of this section, any institution whose total assets at the end of a calendar quarter do not exceed $100,000,000 and which did not increase its total liabilities measured from the corresponding quarter of the preceding year (or, during calendar year 1985, from January 1, 1985) at an annual rate in excess of 15 percent.

(i) Shall have a minimum net-worth-requirement that shall be the sum of the following:

(*a*) Three percent of the average amount of liabilities at the end of that calendar quarter and on the corresponding quarter(s) of one or more of the four immediately preceding years (provided all such years are consecutive);

(*b*) 1/20 of the amortization factor as defined in paragraph (h)(5)(ii) of this section; and

(*c*) The contingency factor;

(ii) Shall calculate any merger, consolidation, or purchase of assets and assumption of liabilities by using pooling-of-interests accounting without regard to the actual method of accounting used; and

(iii) Shall not include any increase in liabilities resulting from a merger, consolidation, or purchase of assets and assumption of liabilities in determining whether the institution increased its liabilities at an annual rate in excess of 15 percent.

(4) *Maintenance requirement*. Institutions shall maintain until the end of the next calendar quarter net worth at least equal to the dollar amount required at the last calendar quarter.

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(c) *Calculation period*. The minimum net-worth requirement shall be calculated as of the end of each calendar quarter and shall be met as of such date.

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(g) *Charging of losses to reserves*. Losses charged to reserves shall exhaust all net-worth accounts before constituting a charge against mutual capital certificates.

(h) *Definitions*. For purposes of this section:

(1) "Total liabilities" means the total assets net of loans in process, specific reserves and deferred credits other than deferred taxes, minus net worth as defined in § 561.13 of this subchapter.

(2) "Base factor" means:

(i) The minimum required net worth for the preceding calendar quarter (except that for the calendar quarter ending March 31, 1985, the minimum required net worth for the beginning of the most recent fiscal year), exclusive of the contingency factor and before reduction for qualifying balances; or

(ii) For any institution involved during a calendar quarter in a merger, consolidation, or purchase of assets and assumption of liabilities, the minimum net-worth requirement (net of the contingency factor and before deductions for qualifying balances) at the end of the preceding calendar quarter, calculated as if the merger, consolidation, or purchase of assets and assumption of liabilities had occured at that date using pooling-of-interests accounting without regard to the actual method of accounting used.

(3) "Growth factor" means:

(i) During a calendar quarter when the institution's total liabilities have increased—

(*a*) Three percent of the increase in total liabilities during the calendar quarter for institutions whose growth in total liabilities measured from the corresponding quarter of the preceding year (or, during calendar year 1985, from January 1, 1985) is at an annual rate of 15 percent or less;

(*b*) Four percent of the increase in total liabilities during the calendar quarter for institutions whose growth in total liabilities measured from the corresponding quarter of the preceding year (or, during calendar year 1985, from January 1, 1985) is at an annual rate greater than 15 percent but not more than 25 percent; or

(*c*) Five percent of the increase in total liabilities during the calendar quarter for institutions whose growth in total liabilities measured from the corresponding quarter of the preceding year (or, during calendar year 1985, from January 1, 1985) is at an annual rate in excess of 25 percent.

(ii) During a calendar quarter when the institution's total liabilities have declined—a negative amount determined by multiplying the decrease in total liabilities during that quarter by a fraction of which the numerator is the "base factor" as of the end of the preceding quarter and the denominator is the "total liabilities" as of the end of the preceding quarter.

(iii) Increases in liabilities resulting from a merger, consolidation, or purchase of assets and assumption of liabilities, shall not be included as an increase in liabilities for purposes of determining the growth factor during that quarter.

(4) The "contingency factor" is the sum of:

(i) Two percent of all loans sold with recourse as that term is defined in § 561.8 of this subchapter;

(ii) Ten percent of investments specified in § 563.9–8(a) of this subchapter made after December 1, 1984, except that investments in service corporations may be excluded if an institution elects to calculate its net-worth requirement on a consolidated basis including that service corporation: *Provided*, that any investments specified in § 563.9–8(a) made by the service corporation shall be included in the total of such investments of the parent institution; and

(iii) 20 percent of the institution's scheduled items.

(5)(i) "Amortization factor" means the amount by which three percent of total liabilities as of December 31, 1984, exceeds

(*a*) Three percent of the average amount on that date and on the corresponding date(s) of one or more of the four immediately preceding fiscal years (provided all such dates are consecutive); or

(*b*) For all insured institutions (other than *de novo* institutions) that have not reached the twentieth anniversary of accounts, the amount specified in paragraph (h)(5)(i)(*a*) of this section multiplied by a fraction of which the numerator is the number of consecutive years of insurance of accounts and the denominator is twenty.

(ii) For any institution whose total assets at the end of a calendar quarter do not exceed $100,000,000 and which did not increase its total liabilities as measured from the corresponding quarter of the preceding year at an annual rate in excess of 15 percent, the "amortization factor" means the amount by which—

(*a*) The amount equal to 3 percent of the average of total liabilities as of December 31, 1984, and on the corresponding date(s) of one or more of the four immediately preceding fiscal years (provided all such dates are consecutive) exceeds.

(*b*) The amount specified in paragraph (h)(5)(ii)(*a*) multiplied by a fraction of which the numerator is the number of consecutive years of insurance of accounts and the denominator is twenty.

(6) "*De novo* institution" means any savings and loan association, homestead association, cooperative bank or savings bank which has filed with the appropriate Federal Home Loan bank an application for insurance of accounts, or an application to organize a Federal association, which was not approved prior to November 3, 1983, and the business of which has not been conducted previously under any charter.

(i) *Expiration date.* This section shall expire on January 1, 1987.

5. Add a new § 563.13–1, as follows:

§ 563.13–1 Liability growth.

(a) No insured institution having total assets in excess of $100,000,000 shall increase its total liabilities within any three-month period at an annual rate greater than 25 percent without prior approval of the institution's Principal Supervisory Agent.

(b) To obtain the prior written approval of the Principal Supervisory Agent, an institution shall submit a written growth plan. A groth plan shall cover a period of time not to exceed one year, and shall include the following information:

(1) The institution's net worth as of the end of the preceding calendar quarter;

(2) The amount of liabilities the institution expects to obtain;

(3) A listing of the proposed sources from whom, and methods by which, the liabilities will be obtained;

(4) The costs, rates, and maturities of liabilities sought to be obtained; and

(5) The planned uses of any liabilities obtained.

(c) No institution shall alter a written growth plan upon which approval has been granted or materially diverge from such a plan without the prior approval of its Principal Supervisory Agent.

(d) A deposit growth plan filed in accordance with paragraph (b) of this section shall be deemed to be approved by the Corporation 30 calendar days after the Principal Supervisory Agent sends written notice to the institution that the plan is complete, unless the Principal Supervisory Agent takes objection to the plan. In determining whether to take objection to a completed growth plan, the Principal Supervisory Agent shall consider the following factors:

(1) The impact of the plan upon the institution's net worth;

(2) The risk of the corresponding investments, the likelihood of obtaining the projected return, and the ability of the institution to underwrite the incremental volume of investments;

(3) The relative maturities of the liabilities and corresponding investments;

(4) The extent to which the liabilities are derived from or through a single source;

(5) Whether the interest to be paid on the liabilities corresponds with generally prevailing rates for similar liabilities;

(6) The financial strength of the institution, including the level of its net worth which shall not be less than 3 percent of total liabilities;

(7) The stability of the institution's earnings over the six preceding calendar quarters; and

(8) The extent to which the institution's policies are consistent with economical home financing.

(e) *Expiration date.* This section shall expire on January 1, 1987.

6. Revise § 563.14 as follows:

§ 563.14 Payment of dividends

No insured institution which has recognized losses of any kind chargeable to its net-worth account may pay dividends to insured members or other account holders, unless (a) its net-worth account, after deduction of such losses, is at least equal to the amount required under § 563.13(b) of this part, or (b) prior written approval is obtained from the Corporation. The Corporation hereby approves for any insured institution which, prior to the charging of such losses, has met the requirement of § 563.13(b), the declaration of dividends to insured members or other account holders, if the insured institution applies not less than 25 percent of its net income (as defined in § 563c.12 of this subchapter) for the affected distribution period to the restoration of its reserve capacity.

PART 570—BOARD RULINGS

§ 570.5 [Removed]

7. Remove § 570.5.

PART 571—STATEMENTS OF POLICY

§ 571.6 [Amended]

8. Amend § 571.6(a)(2) removing the phrase "§ 563.13(a)(2)(ii)(*b*) and (b)(2)(iii)(*b*)" and by substituting the phrase "§ 563.13(b)(2)(ii)".

SUBCHAPTER F—REGULATIONS FOR SAVINGS AND LOAN HOLDING COMPANIES

PART 584—REGULATED ACTIVITIES

§ 584.4 [Amended]

9. Amend § 584.4(g)(1)(iv) by removing the phrase "statutory reserve and".

(Secs. 401, 402, 403, 405, 48 Stat. 1225, 1256, 1257, as amended; 12 U.S.C. 1724, 1725, 1726, 1728, Reorg. Plan No. 3 of 1947, 12 FR 4981, 3 CFR, 1943–48 Comp., p. 1071)

By the Federal Home Loan Bank Board.

J.J. Finn,

Secretary.

[FR Doc. 84-31936 Filed 12-6-84; 8:45 am]

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12 CFR Part 571

[No. 84-679]

Mortgage-Backed Securities

November 30, 1984.

AGENCY: Federal Home Loan Bank Board.

ACTION: Proposed statement of policy.

SUMMARY: The Federal Home Loan Bank Board ("Board"), as the operating head of the Federal Savings and Loan Insurance Corporation ("Corporation"), is proposing to issue a statement of policy concerning the accounting for reverse repurchase agreements, dollar reverse repurchase agreements, dollar reverse repurchase agreements which are rolled forward, and the rollover of forward commitments to acquire mortgage-backed securities for all financial statements submitted to the Board or to the Corporation. The intention of the Board in the proposed statement of policy is to eliminate confusion and inconsistent accounting treatment in this area.